COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY TO AMORTIZE, BY MEANS OF TEMPORARY DECREASE IN RATES, NET FUEL COST SAVINGS RECOVERED IN COAL CONTRACT LITIGATION	)))))	CASE NO. 93-113

O R D E R

In June 1984, Kentucky Utilities Company ("KU") embarked upon litigation with one of its coal suppliers. After proceedings before Fayette Circuit Court, the Kentucky Court of Appeals, and the Kentucky Supreme Court, with forays into the federal courts on the side, this litigation was concluded on February 1, 1993. As a result, KU recovered approximately $44.5 million. Of this amount, the Kentucky retail jurisdictional share is approximately $35.3 million.[1]

Throughout the litigation, KU acknowledged its obligation to return any recovery to its customers and, upon return of the money to it from the Circuit Court, has held the fund in an interest bearing escrow account, subject to the orders of this Commission.

On March 29, 1993, KU filed an application with the Commission requesting authority to refund to its customers these monies including accrued interest, less litigation cost.

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[1] Application filed March 29, 1993, at 5 and Application Exhibit E-8.

The Commission granted motions to intervene filed by the Attorney General, by and through his Utility and Rate Intervention Division ("AG"), Kentucky Industrial Utility Customers ("KIUC"), Lexington-Fayette Urban County Government ("LFUCG"), and the WinterCare Energy Fund, Inc. ("WinterCare").

A public hearing was held on September 28, 1993, with all parties of record represented. Simultaneous briefs were filed on October 18, 1993. All information requested has been submitted.

DISTRIBUTION PLAN

All parties recognize that this application constitutes a unique and extraordinary situation and agree that KU has the obligation to return the escrow funds to its customers. The underlying issue then becomes who is entitled to receive the escrow funds.

It is KU's position that the funds to be refunded to its customers are a reduction in the invoice price of coal. KU argues these coal costs were collected through the Fuel Adjustment Clause ("FAC"), and should be refunded through the FAC by adjustment of the base fuel rate to current customers in compliance with the Commission's FAC regulation, 807 KAR 5:056. In the alternative, KU recommends a one-time refund to current customers. KU reasons that its proposed refund is consistent with Commission practices, reasonable in design, fair to customer classes, practical to implement, and provides for a maximum return of the escrow to the customers. However, KU stated that if the Commission determines an alternative refund plan, it will comply with the decision and

devote its efforts to making the distribution to its customers in a reasonable and timely manner.[2]

The AG and WinterCare submit that equity and fairness require that the customers who paid the coal costs are the ones who should receive the refund. The AG argues that since KU has stressed from the beginning it was acting on behalf of its ratepayers, KU has established a resulting trust with its ratepayers as the beneficiary. The AG also maintains that refunds to current customers would give an unreasonable preference to these current customers who were not on KU's system when the coal costs were collected.

The question of who is entitled to receive the refunds involves numerous issues relating to both fundamental rate-making standards applied by this Commission and basic equity and fairness to utility customers. In order to assess the reasonableness of the two diverse opinions on this issue, the Commission must consider the purpose and intent of the FAC established in 807 KAR 5:056.

After lengthy proceedings involving all interests, in 1977 the Commission, by Order, adopted a uniform FAC to be applicable to all electric utilities in Kentucky. The basic purpose and intent was to provide a vehicle whereby the fluctuations in the cost of fuel could be recognized in rates in a timely fashion, thus avoiding the extensive regulatory lag associated with the filing of periodic general rate cases. The interests of all parties were best served

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[2] KU Brief, at 2.

by establishing a mechanism to reflect both the incremental increases and decreases in fuel costs with only a one month lag and assurances that the automatic adjustments in rates would result in no gain or loss to the utility. The uniform FAC was derived from the clause in effect at the Federal Power Commission, now the Federal Energy Regulatory Commission ("FERC"), and was implemented to replace the existing company specific clauses.

The only connection that the escrow fund has with the FAC regulation is the fact that the funds deposited in the escrow were collected from KU's customers through the operation of the FAC. When it was designed, the FAC regulation simply did not envision the circumstances the Commission is faced with in this proceeding. The use of the FAC to accomplish the refund of the escrow fund is not appropriate. 807 KAR 5:056 narrowly defines what constitutes fuel costs which are recoverable through the mechanism. The refund of the escrow fund does not conform to this narrow definition. The regulation calls for reviews of the operation of the FAC at 6 month and 2 year intervals.

The period of time relating to the collection of the escrow fund falls outside both review periods. Section 11 of 807 KAR 5:056 states, in part, "The Commission will order a utility to charge off and amortize, by means of a temporary decrease of rates, any adjustments it finds unjustified due to improper calculation or application of the charge or improper fuel procurement practices." No evidence has been presented indicating that KU improperly calculated or applied the charge or that improper procurement

practices were in force during the period the escrow fund was collected. Finally, the regulation does not include a section permitting deviations. While KU argues that the deviation provision in 807 KAR 5:011 would allow its requested treatment, that deviation provision applies only to 807 KAR 5:011, not 807 KAR 5:056.

KU contends that its proposed distribution plan is consistent with Commission practice, and cites the Commission's decision in Case No. 90-363-C.[3] This case was a routine 6-month review of the operation of KU's FAC. As part of its calculations in that case, KU included a $4,519 refund it received from an action before the United States Department of Energy, concerning overcharges for fuel oil used at KU's Tryone plant. The overcharges related to fuel oil purchases made between 1973 and 1976. However, the Commission's September 9, 1992 Order in Case No. 90-363-C does not specifically address the acceptance or rejection of KU's treatment of the refund, only that the charges and credits billed by KU through its FAC for the subject period were approved.[4]

While KU may argue that this treatment constitutes an established Commission practice, under those circumstances, the administrative costs that would have been incurred locating the customers who paid for the overcharges and the minuscule amounts

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[3] Case No. 90-363-C, An Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of Kentucky Utilities Company from November 1, 1991 to April 30, 1992, Order dated September 9, 1992.

[4] Id., at 2.

which would have been due those customers, make KU's treatment of that refund the only practical way to flow the refund to customers. This refund was addressed as part of a regular 6 month review, and not as a separate proceeding outside of the FAC review periods. There has been no other evidence presented in this proceeding that would convince the Commission that the refund must be made through the FAC.

Given that the Commission is acting within its statutory responsibility to establish fair, just, and reasonable rates for services rendered and the fact that we are not bound by the FAC regulation to return the KU refund to current customers through the FAC, we are faced with the question of what is fair and equitable for the customers involved in the rates and charges which resulted in the money available for refunds. There appears to be no controversy among the parties that the customers who were receiving service during the period 1985 through 1990 were the customers who provided the subject funds. Likewise, if these funds are deemed to be revenues collected by KU in excess of its actual cost of fuel required to provide utility service, it should be agreed that those same customers paid a rate during that time period which has now been deemed to be excessive.

In consideration of fair, just, and reasonable rates, the Commission cannot ignore issues of equity and fairness, which suggest that to the extent possible every customer is entitled to utility service at a cost which reasonably reflects the utility's cost to provide service. Another aspect of equity and fairness

relates to generational equities, which dictates that today's customers should not have to pay the cost of providing service to past customers. If KU had not collected rates based on the invoiced cost of fuel and then later attempted to recover any cost resulting from a judgment in favor of South East Coal Company ("South East"), the Commission could be in violation of retroactive rate-making if it were to pass those costs on to today's customers through the FAC. At the time the Court authorized KU to deposit disputed fuel cost amounts into an escrow account, KU recognized that if the courts ruled in its favor the money collected from customers, but not paid to South East, would be subject to refund to its customers.[5]

Under KRS 278.190, the Commission may require rates implemented on an interim basis to be collected subject to refund and "[r]equire such utility or utilities to refund to the persons in whose behalf the amounts were paid that portion of the increased rates or charges as by its decision shall be found unreasonable." It is the Commission's belief that the same basic fairness that is implied in the provisions of that statute should apply in this proceeding. This same principle was applied in a decision of the Commission regarding KU in Case No. 5915[6], where KU was required

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[5] Response to Request for Information by Staff Counsel at September 28, 1993 Public Hearing, filed October 25, 1993, Item R-3, "Brief for Plaintiff on Motion for Deposit" filed by KU on January 2, 1985, Appendix A, page 4 of Brief.

[6] Case No. 5915, General Adjustment of Electric Rates of Kentucky Utilities Company.

to refund certain amounts collected subject to refund, with interest upon the culmination of court cases surrounding its earlier decision on rates. In the Commission's point of view, the basic issue of equity applies, even if the rates were not initially implemented under Order subject to refund.

After reviewing this record, the Commission believes it is reasonable and appropriate to make whole the customers who provided the funds deposited in the escrow account. We therefore find that the customers who provided the escrow funds should now be the ones to receive the refund of those funds.

LITIGATION EXPENSE

In its application, KU proposes to offset the proceeds of the escrow fund by $3,010,848, which represents the Kentucky jurisdictional portion of litigation costs KU incurred during the coal contract dispute. KU maintains that the Commission should allow these costs because they are similar to the "buy-outs" and "buy-downs" of coal contracts previously allowed by the Commission. KU also opines that allowing these costs serves as an incentive for utility companies to aggressively pursue price reductions. Finally, KU points out that both the FERC and the Virginia jurisdictions have allowed the litigation expense in their respective distribution plans.

The AG and LFUCG have taken the position that KU is not entitled to the litigation expense. They point out that the rates established in KU's last rate case include an amount for legal expenses and allowing an offset from the escrow funds would be a

double-recovery for KU. They also opine that awarding KU its litigation costs would be a violation of the filed rate doctrine since the FAC regulation does not allow for the recovery of litigation expense through the FAC.

KIUC supports the AG and LFUCG position and points out that allowing the litigation expense recovery to KU would violate four fundamental rate-making principles: (1) it calls for the recovery of a base rate item within the FAC; (2) it violates the prohibition against retroactive rate-making; (3) it constitutes an improper single issue rate case; and (4) is contrary to the position taken by KU in its most recent FAC relating to coal car depreciation.

Although undertaking this litigation was clearly prudent as the final result confirms, a favorable result was by no means assured. In fact, the initial ruling in KU's favor was reversed by the Court of Appeals. Because of its efforts to establish a fund before the Circuit Court which would hold the monies at issue, KU was, at one point in the litigation, faced with counterclaims for abuse of process, wrongful attachment, and punitive damages in excess of $100 million.[7] If KU had not sought establishment of the fund, it might well have faced a judgment-proof defendant as South East's bankruptcy filing subsequently confirmed. KU not only incurred these risks, it incurred additional expenses to defend against these claims.

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[7] Transcript of Evidence ("T.E."), September 28, 1993, at 191-192.

The record indicates that over half of KU's litigation expenses were incurred in its efforts to establish and defend the fund.[8] It is reasonable to conclude from this that half of that half, or one fourth in total, of these expenses was incurred in response to the various counterclaims. Regardless of KU's earnings, had it not taken the risks involved in establishing the fund, there would now be no fund to distribute. We also believe that given the unique nature of this proceeding that KU's incentive argument has some merit. KU's actions concerning the litigation went above and beyond levels which would have normally been expected on a recurring basis. Under the circumstances of this case, it is appropriate for KU to deduct an amount equal to one quarter of its litigation expenses from the fund prior to distribution. This amounts to $752,712.

INTER-SYSTEM SALES

It is the position of KU that they should be allowed to retain the portion of the escrow fund related to inter-system sales. They point out that the FAC recognized inter-system sales by excluding the Kwh sales and the fuel costs associated with inter-system sales. KU further pointed out that under the Federal Power Act, Part II, the Kentucky Commission does not have jurisdiction over inter-system sales. KIUC agrees that KU should retain these funds.

The AG and LFUCG argue that the portion of the escrow fund representing inter-system sales should be refunded to Kentucky

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[8] T.E. at 193-197.

customers or in the alternative to off-system sales customers. Their position is based on the assertion that inter-system sales are market based and the cost of fuel would not affect them, that KU did not give proper notice to customers in the FERC proceeding, and that KU customers have paid for the capacity used to make the sales.

The Commission does not find the AG and LFUCG argument to be valid or persuasive. The record clearly shows that inter-system sales fall under the jurisdiction of the FERC which has made its decision with regard to the FERC jurisdictional portion of the escrow funds.

FEDERAL INCOME TAXES

KU has requested that a portion of the escrow funds be set aside as a contingency in the event the Internal Revenue Service ("IRS") issues an adverse ruling concerning the taxability of the escrow funds. If an unfavorable ruling is received, KU asks that it be allowed to withdraw the actual tax expense from the set aside escrow fund. If the ruling is favorable, the set aside would be returned to customers under the accepted distribution plan.

While it is possible KU might experience taxable income in this tax year because the escrow funds were released to KU and it could not accomplish the refund in this year, this speculative scenario forms no basis for which this Commission can grant KU's request.

EXPANDED NOTICE EXPENSE AND PLAN ADMINISTRATIVE COSTS

KU has requested that the cost of the expanded notice of this proceeding be recovered by offsetting the escrow fund for the actual cost of the notice. Both KU and the AG agreed that any costs incurred to administer the approved distribution plan should be recovered from the escrow fund. The Commission will allow KU to offset the escrow fund for the actual cost of the expanded notice, $83,673[9], and the additional costs to administer the required distribution plan.

UNCLAIMED REFUNDS

WinterCare requested that, if the Commission approved a refund plan which returned the escrow funds to the customers who provided the funds, any unclaimed portion of the escrow fund be distributed to WinterCare. WinterCare in turn would set up a special fund within its existing assistance program to track the use of the distribution in aiding needy families with their electric bills. KU and KIUC both stated that under Kentucky statutes, such a distribution was not permitted; any unclaimed portion of the escrow fund would escheat to Kentucky after seven years.

The Commission would prefer that WinterCare receive any refunds due customers which KU would be unable to locate. But, the strictures of KRS 393.080 bar this Commission from ordering KU to turn over to WinterCare any unclaimed refunds. However, we do

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[9] Response to Request for Information by Staff Counsel at September 28, 1993 Public Hearing, filed October 25, 1993, Item R-1.

encourage KU to present its customers entitled to the refund with the opportunity to have amounts due them contributed in whole or in part to the WinterCare program.

IT IS THEREFORE ORDERED that:

1. KU shall refund the net proceeds of the escrow fund to the customers on its system during the April 1985 through December 1990 period.

2. Within 60 days of the date of this Order, KU shall present a plan for implementation of the distribution required by this Order. This plan shall include, but not be limited to, a discussion of what additional notices will be required and a description of the efforts KU will undertake to locate former customers.

3. The net proceeds from the escrow fund, reflecting approved deductions for litigation expenses and costs for expanded notice, shall be distributed based on the individual customer's actual Kwh usage during the April 1985 through December 1990 period. The distribution to customers still on KU's system shall be made as a single bill credit. The distribution to customers no longer on KU's system shall be made through a single payment.

Done at Frankfort, Kentucky, this 8th day of December, 1993.

PUBLIC SERVICE COMMISSION

Chairman

Commissioner

DISSENT OF VICE CHAIRMAN ROBERT M. DAVIS

Believing that the only lawful and appropriate method for distributing the deposited funds is through KU's fuel adjustment clause, I respectfully dissent.

Notwithstanding the majority's refusal to call a duck a "duck," the deposited funds are fuel costs. All parties to this proceeding have conceded as much. The deposited funds represent a reduction in the invoice price of fossil fuel, are essentially a credit from a fuel supplier, and are properly recorded in Account 151 of FERC's Uniform System of Accounts. They clearly fall within the fuel clause adjustment's definition of fuel cost. 807 KAR 5:056, Section 1, Subsections (3) and (6).

Use of the fuel adjustment clause to distribute the deposited funds, moreover, is consistent with the purpose and intent of 807 KAR 5:056. The purpose of the fuel adjustment clause is not only to ensure that utilities recover their fuel costs but that ratepayers automatically and promptly receive the benefits of any reduction in such costs. Distribution of the deposited funds through the fuel adjustment clause would achieve that result. Even those opposed to using the fuel adjustment clause to distribute the

deposited funds concede that the typical method of distributing refunds from fuel suppliers is the fuel adjustment clause.

Use of the fuel adjustment clause regulation would ensure that all of the deposited funds related to Kentucky retail jurisdictional sales are returned to ratepayers. The regulation would not permit KU to deduct any monies from the deposited funds to cover legal, administrative, and notice expenses. As the monies would be distributed directly to customers currently on KU's system, none would go unclaimed and eventually escheat to the Commonwealth.

Distributing the deposited funds through the fuel adjustment clause, moreover, is the most efficient and cost-effective method. I have long believed that simplicity is a key principle associated with success in business and government. Use of the fuel adjustment clause in this case complies with that principle. In contrast, the majority violates that principle by requiring a method of distribution which is cumbersome, time-consuming, costly, and near impossible to administer.

I am most disturbed about the future implications of the majority's decision. I believe that it does great violence to the fuel adjustment clause regulation. Until today, this Commission has consistently interpreted that regulation as requiring any utility which received a reduction in fuel costs, regardless of the reason for that reduction, to pass that reduction immediately on to

ratepayers.[1] Today the majority jettisons that rule. Future customers are likely to suffer as a result.

Not satisfied with emasculating the fuel adjustment clause regulation, the majority also does a hatchet job on the filed rate doctrine. It contends that the deposited funds represent excessive rates which KU charged from March 1985 to December 1990. These "excessive" rates, the majority therefore reasons, must be refunded to the customers which paid KU rates during that period.

This theory directly contradicts the clear language of KRS 278.270 which provides:

> Whenever the commission, upon its own motion or upon complaint as provided in KRS 278.260, and after a hearing had upon reasonable notice, finds that any rate is unjust, unreasonable, insufficient, unjustly discriminatory or otherwise in violation of any of the provisions of this chapter, the commission shall by order prescribe a just and reasonable rate to be followed in the future. [emphasis added].

KU charged the filed rate throughout the period in question. If it was excessive, as the majority insists, the only available remedy (outside of the fuel adjustment clause) is to prospectively reduce rates.

The majority's suggestion that rates already collected by KU are still subject to refund has no basis in law. No statute contains such provision. KRS 278.190, to which the majority clings

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[1] When confronted with past Commission practice allowing the passthrough of refunded fuel costs through the FAC, the majority chooses to ignore it. It attempts to distinguish these occasions by claiming the amounts involved were minuscule. Unwittingly perhaps the majority therein acknowledges that it is the magnitude of the monies involved and not any legal or equitable principle which guides it.

to for support, provides only a limited exception and is clearly not applicable to the facts of this case.

Several courts have expressly rejected the majority's theory. See Montana Horse Products Co. v. Great Northern R., 91 Mont. 194, 7 P.2d 919, 925 (1932) ("[S]o long as the rates established by the commission are in force, they are presumed to be reasonable, and neither the commission nor the courts have power to retroactively declare such established rates unreasonable."); New England Tele. & Tele. Co. v. Rhode Island Pub. Util. Comm'n, 116 R.I. 356, 358 A.2d 1, 22 (1976) ("[E]stablished rates are presumed to be valid while they are in force and . . . neither the commission nor the court has the power to alter such rates retroactively.").

If the fuel adjustment clause regulation is ignored, then KU's customers have no legal right to any of the deposited funds. As the United States Supreme Court has stated:

> The relation between the company and its customers is not that of partners, agent and principal, or trustee and beneficiary. The revenue paid by the customers for service belongs to the company. The amount, if any, remaining after paying taxes and operating expenses including the expense of depreciation is the company's compensation for the use of its property.

Bd. of Pub. Util. Comm'rs v. New York Tele. Co., 271 U.S. 23, 31 (1926) (citations omitted).

Equally disturbing is the majority's decision to compensate partially KU for its litigation expenses. This clearly violates the regulatory principle prohibiting single issue rate cases. As the Illinois Supreme Court stated in Business & Professional People for the Public Interest v. Illinois Commerce Comm'n, 146 Ill.2d 175, 585 N.E.2d 1032 (1991),

> The rule against single-issue ratemaking recognizes that the revenue formula is designed to determine the revenue requirement based on the aggregate costs and demand of the utility. Therefore, it would be improper to consider changes to components of the revenue requirement in isolation. Often times a change in one item of the revenue formula is offset by a corresponding change in another component of the formula.

Id. at 1061. Moreover, the mathematical gymnastics performed by the majority to determine KU's entitlement to 25 percent of its litigation expenses as an incentive defy logic and the law.

In the final analysis, the majority's decision does a great disservice to the ratepayers. Use of the fuel adjustment clause would have placed into ratepayers' hands the entire $35.3 million within 30 to 60 days. Under the majority's decision, a lesser amount is available for distribution because KU is permitted to charge its administrative, legal and notice costs against the deposited funds. Of that amount, a sizable portion will go unclaimed and eventually escheat to the state, and the time for refunds is still unknown. If there is any winner from today's decision, it is the Commonwealth's treasury.

Robert M. Davis
Vice Chairman

ATTEST:

Executive Director